HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

B-71 Cannon HOB ■ Washington, DC 20515 ■ 202-226-7200 ■ www.house.gov/budget_democrats

July 17, 2002

Dear Democratic Colleague:

The Administration released new deficit projections last Friday showing a further deterioration of the budget outlook. This has focused attention on current financial burdens and on growing future burdens once the Baby Boom generation begins retiring in six short years. Even taking the Administration's rosy numbers at face value, the budget shows on-budget deficits every year for the next decade. This means that Social Security surpluses will continue to be borrowed to fund general government operations.

The attached analysis by the House Budget Committee Democratic staff describes another threat to Americans' future well-being that chronic budget deficits will aggravate. The burgeoning trade deficit already is building up sizeable claims by foreign creditors against future American incomes, and the re-emergence of chronic budget deficits will add to those foreign claims. Burgeoning budget deficits will impose greater burdens on future workers' incomes both by undermining the government's ability to provide Social Security benefits and by boosting interest, dividend, and rent payments to foreign creditors.

As this year's budget debate unfolds, I hope you consider these important but largely unrecognized concerns. If you have any questions about this analysis, please do not hesitate to contact me or the Budget Committee Staff at 226-7200 or at www.house.gov/budget_democrats/.

Sincerely,

John M. Spratt, Jr.
Ranking Member

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Twin Deficits Compound Burden on Future Workers

Much has been made of the burden that the Baby Boom's retirement will impose on today's young people. When the latter become the workforce of tomorrow, they will have to support both themselves and a large dependent population. Far less attention has been paid to the fact that our burgeoning trade deficit[1] is also causing a sizeable buildup of claims by foreign creditors against future American incomes. And almost no one has focused on the fact that the reappearance of chronic federal deficits will add to these foreign claims and the burdens imposed on future workers' incomes.

More of Future Workers' Production Will Be Used to Support Retirees

The Social Security actuaries project that 40 years from now there will be 2.7 people age 25 to 64 for each person over age 64. This will be down from a ratio of 4.7-to-one currently. Because both working people and dependents can derive their livelihoods from Gross Domestic Product only at the time it is produced, future workers will consume a smaller share of the output that they produce.

This does not mean that supporting a larger dependent population will impoverish future workers. That's because productivity will grow. For instance, the Social Security actuaries' assume that capital investment and technological progress will raise output per hour worked 98 percent over the next 40 years — essentially doubling today's productivity. Thus, if workers continue to work the same amount as now and the distribution of income between workers and retirees does not change, inflation-adjusted incomes for workers will still be 75 percent higher than they are now. Workers will receive a smaller share of the output they produce, but gains in productivity will more than offset this, ensuring that they are still substantially better off than today.

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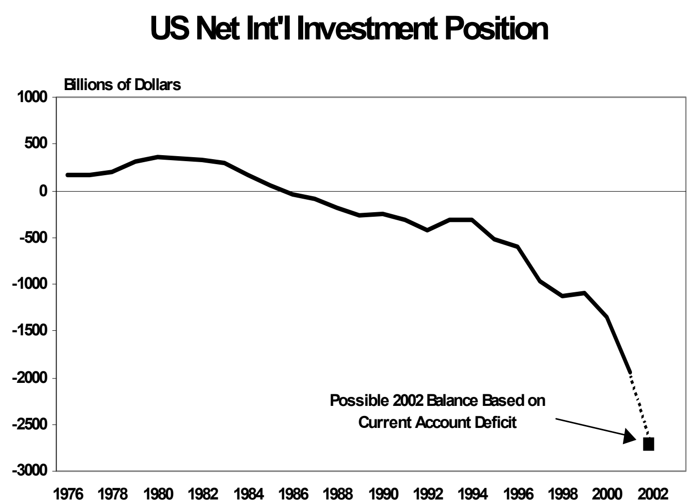
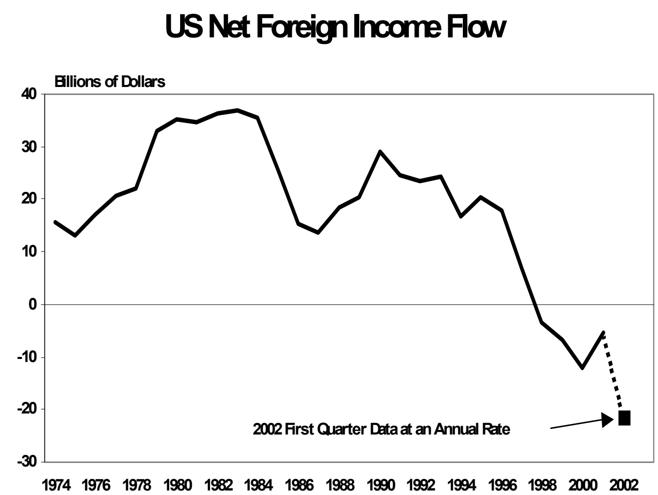
[1] More precisely, it is the current account deficit that is causing the buildup of claims by foreign creditors. There are relatively minor differences between the trade deficit and the current account deficit, such as flows of non-monetary gold and direct payments to foreign governments. However, the largest factor in the current account deficit and the largest factor in the current account deficit's deterioration is the widening trade deficit.

Financial Obligations to Foreign Creditors Add to Claims on Future Incomes

In addition to the claims of a large dependent population, there is another major category of claims against Americans' future incomes. Data released June 28 on the U.S. net international investment position — colloquially known as our foreign debt — point to the fact that the interest, dividends, and rent on investments that foreigners have made here will also claim a significant share of future workers' output. Any time there is a trade deficit because Americans buy more from abroad than we sell to foreigners, investment capital flows into the U.S.





Source: Bureau of Economic Analysis, U.S. Department of Commerce

The charts above illustrate the extent of these claims against future U.S. production. The chart on the left shows the dramatic change in the net international investment position that has transformed the U.S. from the world's largest creditor nation to the world's largest debtor. The chart on the right shows the net flow of dividend, interest, and rent payments associated with this transformation.

The flow of net payments shown on the right does not precisely track the level of net obligations to foreigners shown on the left for a variety of statistical reasons. For instance, our estimates of the flow of net interest, dividend, and rent payments to foreigners did not turn negative until quite some time after the estimated level of net investment did. Still, there is no question about the direction of change or that foreign creditors will be making substantial — and presumably growing — claims against future U.S. incomes.

Foreign investors will insist on getting a stream of payments in return for the funds that they have invested here. The fact that foreign investors have committed something like $2.5 trillion more in the U.S. than we have invested abroad implies that we as a nation will be making such payments for some time to come. This is why a significant share of future GDP produced by U.S. workers and owners of private capital will accrue to foreign creditors rather than to us.

How large might the flow of such payments become? That is difficult to say, though it will almost certainly grow from its modest current pace. For one thing, the U.S. net foreign investment balance continues to deteriorate. The data released on June 28 go only through 2001. Thus far in 2002, foreign investors have continued to invest more here than Americans have invested abroad, and the imbalance is about the same as last year. This suggests that the U.S. net foreign investment balance might deteriorate by about the same amount as it did last year, as shown in the chart above.

More importantly, very few forecasters believe that the U.S. trade deficit will turn around anytime soon or that foreign claims against future U.S. income will not continue to grow. For instance, the economic projection underlying Congressional Budget Office's budget forecast in March 2002 assumed that our external balance will not only stay negative but grow even worse through the end of the decade. If this forecast proves true, it could mean that servicing our foreign debt might require diverting as much as several percentage points of GDP to foreign creditors — that is, hundreds of billions of dollars per year.

Reappearance of Chronic Budget Deficits Creates Further Claims on Future Income

The re-emergence of chronic federal budget deficits threatens to add considerably to these future burdens because of the way widening budget deficits increase U.S. financial obligations to foreign investors. When the government's fiscal position deteriorates, its borrowing increases. Some of the increase in the supply of government bonds is purchased by investors abroad. Interest on those bonds eventually must be paid to the foreign investors, and that interest in turn comes from taxes levied largely on U.S. incomes.

In a sense, interest paid on foreign capital drawn into the U.S. by the deteriorating long-term budget deficit represents a double burden on future workers. When capital comes to this country because foreigners see profitable private-sector opportunities here, those investments themselves create the added future income needed to pay foreign investors. However, when it is government's fiscal mismanagement that draws in capital from abroad, future interest obligations are created without any new productive assets to back them up. In fact, the increase in the government's credit demand due to a widening budget deficit actually reduces productive investment on balance by crowding out private investors seeking credit.

The Size of the Added Foreign Burden Depends on the Extent of Fiscal Deterioration

CBO's March prediction of continuing deterioration of our external imbalance was premised on the belief that the government's budget excluding Social Security would get out of deficit by 2010. Since then, however, it has become apparent that deficits could persist well beyond that, and this implies that the future burden of the external imbalance will be worse as well. The short-term, cyclical deficit depicted by the Administration is actually a long-term structural deficit, promising red ink for years to come. CBO's summer budget update is expected to confirm this.

How much worse the budget outlook will become — and thus how much our financial obligations to foreign creditors will grow — cannot be known. In the late 1990s, we witnessed a sequence of favorable budget revisions measured in trillions of dollars, which in retrospect appears to have been related to the soaring stock market. Now, the budget deficit is widening, and the stock market seems unlikely to return to its previous heights any time soon. This re-emergence of chronic deficits will impose additional financial burdens on the government just as it prepares to meet the fiscal challenges of the Baby Boom's retirement. More importantly, it will impose additional burdens on future workers at the very same time.